Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:TL-N-4515-98
[redacted]

UILC: 881.00-00
1441.02-01

date: APR 05 1999

to: [redacted], Group Manager, CE: [redacted] √
Southern California District

[redacted], International Examiner, E: [redacted] √
Southern California District

[redacted], Revenue Engineer, E: [redacted] √
Southern California District

from: Associate District Counsel, CC:WR:SCA:SD
Southern California District

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subject: **Request for Advisory Opinion**
Taxpayer: [redacted]
EIN: [redacted]

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This responds to your requests for assistance with regard to the above-referenced Taxpayer and the two issues listed below.

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ISSUES:

1. Whether a $[redacted] payment from the Taxpayer to [redacted] constituted insurance under the United States-[redacted] Income Tax Convention and thus is exempt from taxation?

2. Whether the $[redacted] payment is subject to taxation under I.R.C. § 881(a) and as such is subject to withholding tax under I.R.C. §§ 1441-1446?

CONCLUSIONS:

1. The payment does not constitute insurance and thus is not exempt from taxation.

2. The payment is subject to taxation under I.R.C. § 881(a) and as such is subject to withholding tax under I.R.C. §§ 1441-1446.

FACTS:

As to the facts in this case, our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

The [redacted] was initiated to develop a [redacted] in [redacted], New York. The project consisted of three phases: (1) pre-construction development; (2) construction; and (3) post-construction operation. On [redacted] the corporation later known as [redacted] ("Taxpayer") and [redacted] executed a MEMORANDUM OF UNDERSTANDING ("MOU"). The MOU states in toto as follows:

> This Memorandum of Understanding ("MOU") dated this [redacted] day of [redacted] is made by and between [redacted], a [redacted] corporation ("[redacted]"), and [redacted], a California corporation ("[redacted]") [later [redacted].
>
> 1. **General** [redacted] and [redacted] desire to participate with [redacted] ("[redacted]") as co-developer in the development of its [redacted] (the "Project") to be located near [redacted], New York State.

2. **Development Loan** Along the line of [redacted]s corporate policy regarding the promoting US project that a high risk profile project is pursued through a special purpose subsidiary, [redacted] through its [redacted] ("[redacted]") will promote the development of Project by providing a development fund to the Project. In return, [redacted] will be entitled to receive a return on such development loan and development fee to allowed in the Project.

3. **Equity Underwriting** For consideration and in return of providing back-up guaranty for [redacted]'s equity contribution obligation to the Project and of arranging source of the funds for [redacted]'s actual equity contribution. [redacted] will be transferred [redacted]'s rights to receive a equity distribution ("Receiving Right") from the Project which [redacted] is entitled to receive.

4. [redacted] **Optional Right** [redacted] has an option to request [redacted] to transfer the Receiving Rights back to [redacted] upon the construction closing of the Project as the fair market value basis.

IN WITNESS WHEREOF, the parties have executed this Memorandum of Understanding on the date first above written.

In a JOINT DEVELOPMENT AGREEMENT dated [redacted] ("JDA") between [redacted] and the Taxpayer, the Taxpayer committed to provide a loan to [redacted], a limited partnership, in the amount of $[redacted] The $[redacted] loan commitment was part of the pre-construction phase of the [redacted] On [redacted], the Taxpayer's development loan was repaid in full and the Taxpayer received compensation therefore in the form of a Development Fee in the amount of approximately $[redacted] The JDA states in pertinent part:

> 5.1 [redacted] Underwriting. (a) [redacted] shall provide, as of the Construction Loan Closing, a commitment to contribute at the time described in Section 4.1 hereof equity funding for that portion of the Project Cost not funded from the proceeds of term debt provided by the Senior Lender but in any event an amount not to exceed the least of: (i) [redacted] percent of the Project Cost (as agreed with the Senior Lender at the Construction Loan Closing); (ii) $[redacted]; (iii) subject to Section 5.2 hereof, the amount requested by [redacted] pursuant to Section 5.4 hereof (such commitment, the "Underwriting Obligation"), subject to the following conditions precedent . . . .
>
> 10.10 [redacted] Guaranty. On the Closing Date, [redacted] shall deliver to [redacted] the executed guaranty of [redacted] in the form of Exhibit E hereto in respect of [redacted]'s obligations under Section 5.1 hereof.

We do not have a copy of the Exhibit E to the JDA.

An AMENDED AND RESTATED AGREEMENT OF LIMITED PARTNERSHIP, dated [redacted] ("partnership agreement") was executed between [redacted], as the general partner and a limited partner, and [redacted] ("[redacted]") and [redacted]"), as limited partners. [redacted] and [redacted] were wholly-owned special purpose subsidiaries of the Taxpayer. The partnership agreement states in pertinent part:

> 3.1. Capital Contributions.
>
> . . . .
>
> (b) On the Term Loan Closing Date, (i) the [redacted] Limited Partners [previously defined therein as "collectively, [redacted] and all Limited Partners who directly or indirectly acquired Limited Partner Interests from [redacted]; "[redacted] Limited Partner" means any one of them"] shall contribute $[redacted] to the capital of the Partnership . . . .
>
> (c) The Partners shall have no obligation to make any contributions to the capital of the Partnership beyond those provided in this Section 3.1.

In the partnership agreement, other partners also agreed to make capital contributions to [redacted].

By letter dated [redacted], the Taxpayer notified [redacted] in pertinent part: The letter states <u>in</u> <u>toto</u> as follows:

> Pursuant to No. 4 of the Memorandum of Understanding dated [redacted] of [redacted], [redacted] executes the Optional Right as the following condition;
>
> 1. [redacted] will relinquish the Receiving Rights based on the market value (current condition is the net present value based on [redacted]).
>
> 2. [redacted] requests [redacted] to arrange the guaranty as the equity contribution commitment under the construction period.
>
> 3. After the construction closing, based on the Project Base Case Cash Flow, the amount will be determined as soon as possible.
>
> If you agree the above conditions, please sign and return the copy of this letter. [redacted] will proceed all documentation under [redacted] name.

On [redacted], the Taxpayer and [redacted] executed an AGREEMENT OF CLARIFICATION. The AGREEMENT OF CLARIFICATION states in toto as follows:

> This Agreement of Clarification dated this [redacted] day of [redacted] is made by and between the parties to a certain Memorandum of Understanding ("MOU", copy attached) dated [redacted], to wit, [redacted] and [redacted] ([redacted]). The parties agree that:
>
> 1. [redacted]'s obligations under paragraph 3 of the MOU apply during the construction period only, such period beginning on the date the construction loan closed and ending upon completion of construction.
>
> 2. The Receiving Right mentioned in the MOU constitutes an undertaking by [redacted] to pay [redacted] for [redacted]'s undertakings in paragraph 3 of the MOU by remittances out of a portion of the equity distributions and merely represents an agreed-upon means by which to pay a fee to [redacted] for its surety and assistance services and not a payment to [redacted] for any kind of property interest.
>
> 3. The remittances specified in paragraph 2 hereof are intended to compensate [redacted] for its undertakings arising pursuant to paragraph 3 of the MOU, such amount having a quantifiable value to which the parties agreed at the time of the original execution of the MOU.
>
> 4. The option available to [redacted] in paragraph 4 of the MOU is a lump sum payment option that represents an election available to [redacted] to prepay its fee at fair market value and not to purchase any kind of property right from [redacted]
>
> IN WITNESS THEREOF, the parties have executed this Agreement on the date first above written.

Also on [redacted], the Taxpayer and [redacted] executed an AGREEMENT. The AGREEMENT states in toto as follows:

> This Agreement is made and entered into as of [redacted] by and between [redacted] (formerly [redacted], a corporation organized and existing under the law of the State of California, having its office at [redacted] (hereafter referred to as "[redacted]") and [redacted] a corporation organized and existing under the law of [redacted], having its office at [redacted], [redacted], [redacted] [redacted] (hereafter referred to as "[redacted]").

Pursuant to No. 4 of the Memorandum of Understanding dated [redacted] of [redacted], [redacted] and [redacted] agree to execute the Option Right, as following conditions;

1. Refer to the attached Base Case Cash Flow, [redacted] should pay to [redacted] US$[redacted] (say [redacted]).

2. [redacted] should pay the above amount by [redacted].

IN WITNESS WHEREOF, the parties have executed this Agreement on the date first above written.

In [redacted], pursuant to the [redacted] letter, the Taxpayer paid [redacted] $[redacted].

On or about [redacted] and [redacted] made capital contributions to [redacted] totaling $[redacted]. [redacted] and [redacted] executed promissory notes in favor of [redacted], a wholly owned subsidiary of [redacted], pursuant to which [redacted] and [redacted] borrowed the funds necessary to make the equity contributions to [redacted].

On the [redacted] Form 1120 for the Taxpayer and its subsidiaries, $[redacted] for [redacted] and $[redacted] for [redacted] was deducted as "AMORTIZATION -- IN SERVICE PRIOR YEAR" on line 26 "Other deductions."

The notes to the consolidated financial statements for the taxable period [redacted] state in pertinent part:

> [redacted]'s [redacted]'s [redacted]% and [redacted]%, respectively, limited partner interest in [redacted]). In accordance with the partnership agreement, [redacted] and [redacted] are obligated to fund total capital contributions of $[redacted]. The contributions are guaranteed by [redacted]. In return for the guarantee, [redacted] is entitled to [redacted]% of the net income of [redacted] and [redacted]. The project commenced operations in [redacted]. Total contributions to [redacted] amounted to $[redacted] at [redacted] of which $[redacted] was made during [redacted]. Total distributions received from [redacted], included in income, amounted to $[redacted] for the year ended December 31, [redacted]. Amortization expense amounted to $[redacted] for the year ended December 31, [redacted]. [redacted] paid [redacted] a $[redacted] fee relating to services provided by [redacted] in connection with securing [redacted]'s limited partnership in the [redacted] project. This fee has been capitalized over the estimated life of the project (30 years). The unamortized amount of the fee was $[redacted] as of [redacted].

Amortization expense amounted to $[redacted] for the year ended December 31, [redacted].

The Taxpayer's latest explanation of the $[redacted] payment (the reply to Information Document Request I.E. #2 dated [redacted], response provided to IRS [redacted]), a copy of which is attached as Exhibit A, states in pertinent part:[1]

> 7a. The $[redacted] payment was compensation to [redacted] for guaranteeing the development loan between [redacted] and [redacted] and for guaranteeing the $[redacted] capital contribution obligations of [redacted] and [redacted].
>
> . . . .
>
> 7c. Since [redacted] was compensated for guaranteeing two payments which were made in succession, first the development loan and then the equity contributions, the $[redacted] asset was amortized by [redacted] for tax purposes over [redacted] and [redacted]. Note that the Construction Loan Closing date was [redacted] and [redacted] was the date on which the full $[redacted] capital contribution obligation of [redacted] and [redacted] had been satisfied. However, the $[redacted] payment which gave rise the amortizable asset did not take place until [redacted]. Accordingly, amortization was split equally between the [redacted] and [redacted], i.e., nine months of amortization in each year.

[1] The assertion that the $[redacted] was compensation for guaranteeing both the development loan and the equity contributions conflicts with statements made in a prior Taxpayer memorandum, a copy of which is attached as Exhibit B. In the prior Taxpayer memorandum, the $[redacted] was stated to be compensation for guaranteeing only the equity contributions, not the development loan as well. Likewise, the notes to the Taxpayer's financial statements and, most importantly, paragraph 3 of the MOU itself impliedly states that the $[redacted] was compensation for guaranteeing only the equity contributions, not the development loan as well. Finally, the development loan was made and paid back in [redacted]. If part of the $[redacted] was compensation for guaranteeing the development loan, it would seem that part of the $[redacted] should have been deducted in [redacted].

LAW AND ANALYSIS:

1. THE [redacted] PAYMENT FROM THE TAXPAYER TO [redacted] DID NOT CONSTITUTE INSURANCE UNDER THE UNITED STATES-[redacted] INCOME TAX CONVENTION AND THUS IS NOT EXEMPT FROM TAXATION.

The Taxpayer contends that the payment was paid in exchange for [redacted] agreeing to guarantee [redacted] and [redacted]'s capital contributions and as such constituted insurance under the laws of the United States, as incorporated into the United States-[redacted] Income Tax Convention, and as such is exempt from taxation because [redacted] did not maintain a permanent establishment in the United States.

[redacted] of the United States-[redacted] Income Tax Convention, [redacted], ("treaty") states in pertinent part:

> Industrial or commercial profits of a resident of a Contracting State shall be exempt from tax by the other Contracting State unless such resident is engaged in industrial or commercial activity in that other Contracting State through a permanent establishment situated therein. . . .

[redacted] of the treaty provides a non-exclusive list of activities from which industrial or commercial profits may arise, stating, in pertinent part:

> The term "industrial or commercial profits" includes income derived from . . . insurance . . . from the furnishing of personal services . . . .

[redacted]

The Taxpayer attempts to fit the payments at issue into the cubbyhole of "industrial or commercial profits" by characterizing them as being "insurance." The payments did not constitute insurance. Insurance is not specifically defined in the treaty. [redacted] of the treaty provides in pertinent part:

> As regards the application of this Convention by a Contracting State, any term used in this Convention and not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention.

Thus we turn to general federal income taxation principles to discern the meaning of "insurance." The Taxpayer cites United States v. Home Title Insurance Company, 285 U.S. 191 (1932), to support its position. While the Taxpayer is correct that Home Title holds that making a guarantee can constitute insurance, this misses the point. If a guarantee transaction involves risk-transfer and risk-distribution then it could constitute insurance. It is not the type of risk, but rather risk-transfer and risk-distribution that give rise to insurance. Helvering v. Le Gierse, 312 U.S. 531 (1941); Gulf Oil Corp. v. Commissioner, 89 T.C. 1010 (1987), aff'd 914 F.2d 396 (3rd Cir. 1990).

Under the principles of the insurance industry, risk distribution occurs only when there are sufficient unrelated risks in a given pool for the law of large numbers to operate. Gulf, 89 T.C. at 1025. Here, there is no evidence that [redacted] pooled the possibility that it would have to pay [redacted]'s and/or [redacted]'s capital contributions with any other risk. Apparently, the payment was simply paid to [redacted] and [redacted] agreed to make the capital contributions to [redacted] if [redacted] and/or [redacted] was unable to do so. [redacted] did not pool the risk of having to fulfill this obligation with the possibility of having to fulfill any similar obligation. In short, there is no evidence that any risk distribution occurred in the context of the instant payments. Thus, for this among other reasons, the payment did not constitute insurance.

Further, the technical explanation to the treaty clarifies that only income resulting from the active conduct of a trade or business may constitute industrial or commercial profits. [redacted]. Thus, the payments to [redacted] could constitute industrial or commercial profits only if [redacted]'s guarantee of the equity contributions is part of the active conduct of a trade or business or independently constituted an active trade or business. The Taxpayer has proffered no evidence of this.

2. THE PAYMENT IS SUBJECT TO TAXATION PURSUANT TO I.R.C. § 881(a) AND AS SUCH IS SUBJECT TO A WITHHOLDING TAX OF 30 PERCENT UNDER I.R.C. §§ 1441 THROUGH 1446.

From the broad perspective, the execution of the MOU and subsequent events described in the facts section can be viewed as either (1) transfer of a property interest, i.e., the Receiving Rights, to [redacted] followed by [redacted] transferring that property interest back to the Taxpayer in exchange for the $[redacted] or (2) an agreement for [redacted] to provide a guarantee and to be compensated as equity distributions were received by the Taxpayer. Either of these two scenarios would only apply to the extent that the transactions were at arms' length.

We conclude that the payment constituted "other fixed or determinable annual or periodic . . . income" from sources within the United States subject to United States income taxation pursuant to I.R.C. § 881(a) that is not impacted by the treaty. As such, the payment was subject to a withholding tax of 30 percent under I.R.C. §§ 1441 through 1446. To implement this theory, we need only accept the Taxpayer's characterization of the payment as constituting a "guarantee" and accept the Taxpayer's assertions in the AGREEMENT OF CLARIFICATION that the MOU merely represented an attempt by the Taxpayer to prepay its fee.

I.R.C. § 881 imposes a tax of 30 percent of "the amount received from sources within the United States by a foreign corporation as . . . and other fixed or determinable annual or periodical gains, profits, and income."[2] [redacted] was a foreign corporation. [redacted] received a payment from the Taxpayer. Thus, we must determine (1) whether the payment was from "sources within the United States"; (2) whether the payment constituted "other fixed or determinable annual or periodical gains, profits, and income"; (3) whether the treaty impacts or overrides the statutorily prescribed treatment of the payment; and (4) whether, assuming that the payment is taxable under I.R.C. § 881, the payment is subject to a withholding tax of 30 percent under I.R.C. §§ 1441 through 1446.

THE PAYMENT WAS FROM "SOURCES WITHIN THE UNITED STATES"

[redacted] of the treaty contains the treaty sourcing provisions. Sections [redacted] prescribe rules for different types of income. Section (9) provides that the source of income for other types of income "shall be determined by each of the Contracting States in accordance with its own law."

I.R.C. § 863(a) provides that "items of gross income . . . other than those specified in sections 861(a) and 862(a), shall be allocated or apportioned to sources within or without the United States, under regulations prescribed by the Secretary . . . ." The sourcing of guarantee income is not addressed by either I.R.C. § 861(a) or I.R.C. § 862(a).

In the absence of a specific code provision governing the source of an income item, courts have usually first looked to analogous types of income with specific statutory rules. Bank of America v. United States, 680 F.2d 142 (Ct. Cls. 1982). In Bank of America, the Court of Claims sourced both acceptance commissions and confirmation commissions pertaining to letters of credit at the residency of the obligor. The court found that the primary function the Taxpayer therein performed to earn the commissions was the substitution of its own credit for that of others. Because of the similarity of this primary function with providing a loan, the court held that the commissions should be sourced analogous to interest. As now, as a general matter interest was sourced at the residency of the obligor. Accordingly, since the obligors

[2] The Taxpayer has not contended that [redacted] had a trade or business within the United States.

therein were all foreign banks, the court held that the commissions were foreign source income. Likewise, the Tax Court in Howkins v. Commissioner, 49 T.C. 689 (1968), sourced alimony payments to the residency of the obligor. In Howkins the Tax Court stated in pertinent part:

> Especially instructive for our purposes is the source-of-income rule provided by statute for the payment of interest, for, like alimony, interest involves an obligation, usually to make periodic payments over a period of time, which is not incurred in exchange for property or services. Lacking these touchstones, Congress turned to the residence of the obligor--the situs of the debt-- as the place where the income is produced, and thus the source of the income. See § 861(a)(1), I.R.C. 1954. As was said in A.C. Monk & Co., 10 T.C. 77, a case in which a domestic (and, therefore, resident) corporation was required to withhold a tax on interest paid to a nonresident alien in spite of the fact that the interest payments were made from a foreign bank account and were derived from foreign income (at p. 82):
>
>> This obligation has its source in the obligor, and thus the source of the payment of the obligation is the residence of obligor. There the right of payment arises and there the right may be enforced. The only qualification is that the payment be actually made by the resident obligor or on its behalf and pursuant to its obligation. * * *
>
> We think the considerations taken into account in Monk are equally applicable here and we hold that the alimony payments had their source in the United States.

Howkins, 49 T.C. at 694 (footnote omitted).

I.R.C. § 861(a) states in pertinent part:

> (a) GROSS INCOME FROM SOURCES WITHIN THE UNITED STATES.-- The following items of gross income shall be treated as income from sources within the United States:
>
>> (1) INTEREST.-- Interest from . . . interest-bearing obligations of . . . domestic corporations . . . .

For the instant issue, a court would very likely source the guarantee fee analogously to interest and, because the obligor is a U.S. [redacted] corporate entity, the payment would be held to be from "sources within the United States."

THE PAYMENT CONSTITUTED "OTHER FIXED OR DETERMINABLE ANNUAL OR PERIODICAL GAINS, PROFITS, AND INCOME"

In Wodehouse v. Commissioner, 337 U.S. 369 (1948), the Supreme Court opined that the predecessor of I.R.C. § 881 should be construed broadly. The Court looked back to Helvering v. Stockholms Enskilda Bank, 293 U.S. 84 (1935), in which the Court had stated in pertinent part:

> The general object of this act is to put money into the federal treasury; and there is manifest in the reach of its many provisions an intention on the part of Congress to bring about a generous attainment of that object by imposing a tax upon pretty much every sort of income subject to the federal power. Plainly, the payment in question constitutes income derived from a source within the United States; and the natural aim of Congress would be to reach it . . . .

Stockholms Enskida Bank, 293 U.S. at 89.

Our research unearthed no cases in which a taxpayer successfully argued that a certain item of income was not fixed or determinable annual or periodical gains, profit and income ("FDAP income") without also successfully placing the income into another statutorily defined category such as trade or business income subject to I.R.C. § 882, not I.R.C. § 881. As the Supreme Court explained in Wodehouse, I.R.C. § 881(a) cuts a wide swath. The payment at issue herein surely falls within this wide swath.[3]

THE TREATY DOES NOT IMPACT OR OVERRIDE THE STATUTORILY PRESCRIBED TREATMENT OF THE PAYMENT

Aside from their "insurance" argument addressed above, the Taxpayers have not argued that the payment is impacted by or subject to the treaty. [redacted] of the treaty provides that "industrial or commercial profits" of a resident of a Contracting State shall be exempt from tax by the other Contracting States unless such resident is engaged in industrial or commercial activity in that other Contracting State through a permanent establishment situated therein. [redacted] defines the term "industrial or commercial profits" to include "income derived from manufacturing, mercantile, insurance, agriculture, fishing, or mining activities, from the operation of ships or aircraft, from the furnishing of personal services, and from the rental of tangible personal property (other than ships or aircraft)." The technical explanation to the treaty provides that the term "industrial or commercial profits" is "defined by setting forth several examples of activities which constitute the active

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[3] A single lump sum can be FDAP income. Wodehouse, 337 U.S. at 393.

conduct of a trade or business." Technical Explanation to the Treaty, [redacted].

The "payment" did not derive from one of the enumerated types of income and the guarantee activity did not constitute the active conduct of a trade or business. Thus, [redacted] does not exempt the payment from federal income taxation.

No other provision of the treaty applies to the payment. Thus, the pertinent code sections prescribe the proper treatment of the payment.

THE PAYMENT IS SUBJECT TO A WITHHOLDING TAX OF 30 PERCENT PURSUANT TO I.R.C. §§ 1441 THROUGH 1446

I.R.C. § 1441 through 1446 provide that a payor shall deduct and withhold a tax equal to 30 percent of a payment to a foreign corporation that constitutes "other fixed or determinable annual or periodical gains" and is not impacted by a treaty.

THE $[redacted] PAYMENT COULD POSSIBLY BE VIEWED AS A PAYMENT BY THE TAXPAYER IN EXCHANGE FOR A PARTNERSHIP INTEREST IN [redacted]. HOWEVER, IT IS UNLIKELY THAT THE TAXPAYER WOULD BE SUBJECT TO I.R.C. 1441 THROUGH 1446 WITHHOLDING TAX UNDER THIS SCENARIO.

We now address the consequences of viewing the execution of the MOU and subsequent events as a transfer of a property interest, i.e., the Receiving Rights, to [redacted] followed by [redacted] transferring that property interest back to the Taxpayer in exchange for the $[redacted] payment in [redacted].

Under this scenario, in substance, when the MOU was executed the Taxpayer promised to transfer the Receiving Rights to [redacted] when it or its subsidiaries obtained same. In [redacted], [redacted] obtained the Receiving Rights. Thus, at the start of [redacted], [redacted] owned the Receiving Rights.

Because this advisory opinion pertains only to taxable periods [redacted] and [redacted], we do not address the tax consequences of the transactions in which [redacted] obtained the Receiving Rights. Our initial impression is that, when [redacted] obtained the Receiving Rights in [redacted], the Taxpayer made a distribution with respect to stock to [redacted]. This is because [redacted] in substance became the partner in [redacted] and in substance assumed the obligation to make the equity contributions itself, rather than just guaranteeing the Taxpayer's equity contribution obligation. To the extent that the Taxpayer had current or accumulated earnings and profits, a constructive dividend resulted. Withholding tax pursuant to

I.R.C. §§ 1441 through 1446 would apply. For purposes of addressing [redacted] and [redacted] at the start of [redacted] and [redacted], [redacted] would have a basis in the Receiving Rights equal to the fair market value of the Receiving Rights at the time that they were transferred to [redacted] in [redacted].

IF THE RECEIVING RIGHTS WERE NOT A PARTNERSHIP INTEREST, THE PAYMENT WOULD NOT BE TAXABLE.

If the receiving rights were a property interest, then they were a capital asset. I.R.C. § 1221. [redacted] of the treaty provides that, with certain inapplicable exceptions, gains from the sale, exchange, or other disposition of capital assets derived by a resident of [redacted] are exempt from taxation by the United States.

IF THE RECEIVING RIGHTS WERE A PARTNERSHIP INTEREST, ONLY ANY APPRECIATION BETWEEN THE TIME THAT [redacted] ACQUIRED THE PARTNERSHIP INTEREST AND THE AGREEMENT TO SELL THE PARTNERSHIP INTEREST BACK TO THE TAXPAYER WOULD BE SUBJECT TO FEDERAL INCOME TAXATION. ANY SUCH GAIN WOULD NOT BE SUBJECT TO I.R.C. §§ 1441 THROUGH 1446 WITHHOLDING.

The MOU could be construed as a promise by the Taxpayer to transfer its, or its subsidiaries,' partnership interest in [redacted] to [redacted] as soon as it obtained that partnership interest. If so, then the $[redacted] payment was in exchange for a partnership interest.

The Receiving Rights represented "[redacted]'s rights to receive a equity distribution ("Receiving Right") from the Project which [redacted] is entitled to receive." While "partner" and "partnership" are defined in the Code, "partnership interest" is not. The Receiving Rights appear to be only a profits interest. However, as limited partners, the [redacted] entities were at risk of losing only their capital contributions in any event. The sharing of losses is not a requisite condition for the existence of a partnership. McDougal v. Commissioner, 62 T.C. 720 (1974); 70 Acre Recognition Equipment Partnership, Booth Creek Investment, Inc., Tax Matters Partner v. Commissioner, T.C. Memo. 1996-547. While whether a partnership exists is a different question from the one at hand, it is sufficiently conceptually similar for cases addressing it to be instructive. Further, it is possible for a corporation to hold a partnership interest as a nominee in certain circumstances. Red Carpet Car Wash, Inc., v. Commissioner, 73 T.C. 676. Such circumstances are rare, and in the instant case, whether [redacted] and [redacted] could be found to be the nominee of [redacted] is not certain. For purposes of discussion, we will so assume.

A foreign partner is deemed to have a permanent establishment in the United States if the partnership has a permanent establishment in the United States. Donroy, Ltd., et. al. v. Commissioner, 301 F.2d 200 (9th Cir. 1962); Unger v. Commissioner, T.C. Memo. 1990-15. Although we found no Treasury Regulations or cases holding that sale by a foreign partner of a partnership with a permanent establishment in the United States is gain effectively connected therewith, Rev. Rul. 91-32, 1991-1 C.B. 107 so provides.

When in [redacted], the Taxpayer transferred the Receiving Rights to [redacted], [redacted] likely received income subject to taxation to the extent of the fair market value of the guarantee it provided coupled with a distribution with respect to stock equal to the difference between the fair market value of the Receiving Rights and the fair market value of the guarantee. At the start of taxable period [redacted], [redacted] had a basis in the Receiving Rights equal to the fair market value of the Receiving Rights. I.R.C. §§ 1012 and 301(d). Thus, the $[redacted] payment would only be taxable to the extent that $[redacted] exceeds the fair market value of the Receiving Rights when in [redacted] they were transferred to [redacted]

Further, while any such gain would be gain effectively connected with a permanent establishment in the United States, such gain would not be subject to I.R.C. §§ 1441 through 1446 withholding. I.R.C. § 1446, "WITHHOLDING TAX ON FOREIGN PARTNERS' SHARE OF EFFECTIVELY CONNECTED INCOME," provides in pertinent part:

> (a) GENERAL RULE.--If--
>
> (1) a partnership has effectively connected taxable income for any taxable year, and
>
> (2) any portion of such income is allocable under § 704 to a foreign partner,
>
> such partnership shall pay a withholding tax under this section at such time and in such manner as the Secretary shall by regulations prescribe.
>
> (b) AMOUNT OF WITHHOLDING TAX--
>
> (1) IN GENERAL.-- The amount of the withholding tax payable by any partnership under subsection (a) shall be equal to the applicable percentage of the effectively connected taxable income of the partnership which is allocable under section 704 to foreign partners.

. . . .

(c) EFFECTIVELY CONNECTED TAXABLE INCOME.-- For purposes of this section, the term "effectively connected taxable income" means the taxable income of the partnership which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States computed with the following adjustments . . . .

The text of I.R.C. § 1446 speaks in terms of "income of the partnership" and provides that the partnership is who shall be responsible for the withholding tax. It does not appear that any withholding responsibility applies to the purchaser of a partnership interest. We found nothing in the Treasury Regulations underlying I.R.C. § 1446 nor in Rev. Proc. 89-31, 1989-1 C.B. 895, the Revenue Procedure providing guidance under I.R.C. § 1446, indicating that I.R.C. § 1446 would apply to sales of partnership interests.

THE PURPOSE OF THE $[redacted] PAYMENT WAS TO ENABLE THE TAXPAYER TO ACQUIRE AN EQUITY INTEREST IN [redacted], AND THUS, IT SHOULD BE ADDED TO THE BASIS OF THE [redacted] PARTNERSHIP INTEREST, NOT DEDUCTED.

If the payment was incurred to guarantee the equity contribution, then the expenditure was incurred to enable the Taxpayer (or [redacted] and [redacted]) to obtain an interest in [redacted]. If the payment was made to re-acquire the Receiving Rights, then the payment was made in exchange for the Receiving Rights. Amounts expended to acquire a capital asset must be capitalized. Woodward v. Commissioner, 397 U.S. 572 (1970).

OTHER POINTS

Either of the two above scenarios would only apply to the extent that the transactions were at arms' length. To the extent that the $[redacted] payment exceeded the fair market value of the guarantee, [redacted] received a distribution with respect to stock. Dodd v. Commissioner, T.C. Memo 1998-231. This portion can be disallowed as a deductible expenditure under both I.R.C. § 162 and I.R.C. § 482. To the extent of the Taxpayer's current or accumulated earnings and profits at that time, the payment would constitute a dividend. I.R.C. §§ 301 and 316. With respect to that portion of the payment, the Taxpayer would be subject to a I.R.C. §§ 1441 through 1446 withholding tax at the reduced rate of 10 percent pursuant to [redacted] of the Treaty. That portion of the payment would neither be deductible nor be a proper addition to the basis of [redacted].

It would appear that [redacted] and [redacted], not the Taxpayer obtained the [redacted] interest. Thus, as reflected by the Taxpayer in its return, the attendant consequences of the payment may belong to [redacted] and [redacted] not the Taxpayer. With respect to any potential deduction or addition to the basis of [redacted] this should not change our analysis, as long as the Taxpayer, [redacted] and [redacted] continue to file a consolidated return. Any such potential deduction or addition to the basis of [redacted] would take place at the [redacted] and [redacted] level. In substance, the Taxpayer would be viewed as making a constructive contribution to the capital of [redacted] and [redacted], followed by [redacted] and [redacted] making the payment to [redacted] Rev. Rul. 84-68, 1984-1 C.B. 31. Neither would this change any federal income taxation consequences to [redacted]. However, this could potentially change the I.R.C. §§ 1441 through 1446 withholding consequences. While the Taxpayer would remain liable for the withholding tax as the party that actually made the $[redacted] payment, [redacted] and [redacted] would also be liable for such withholding tax. Casa De La Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990).

If you have any questions, please call [redacted] at [redacted].

Sincerely,

[redacted]
Associate District Counsel

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attachments:

As stated √

cc: Assistant Regional Counsel (TL) √
Western Region
(w/o attachments)